Why All the Interest in Interest Rates?

For the past few weeks, one of the major topics of conversation has been interest rates and the impact they could have on the capital markets if they rise. Ironically, good economic news delivered weeks ago about gross domestic product growth, job creation and corporate earnings sent the equities markets on a rollercoaster ride, mainly based on the expectation that all of this healthy economic news would cause interest rates to rise faster, and to a greater extent, than expected.

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For more than two years now, the Fed has been telegraphing that rates would be increasing with two to three one-quarter point increases per year. The positive economic news has left market participants feeling as if rate increases might outpace the Fed's projected slow, steady climb.

The general feeling among commercial real estate players is that interest rate hikes are bad for the market. While it is true that low interest rates are rocket fuel for real estate capital markets, increases in rates are not necessarily bad.

If you are a frequent reader of Concrete Thoughts, you know that I always say that it is not "if" rates increase but "why" they increase. If rates increase because of stagnation in the economy, a decrease in the amount of available credit, an increase in the demand for credit or because we are having trouble selling bonds, those increases are negative for commercial real estate. However, if rates increase because the economy has tangible positive traction, rate increases can ultimately be positive.

Yes, it is true that interest rates and capitalization rates are highly correlated over the long term, so if interest rates rise, cap rates will also rise. Rising cap rates exert downward pressure on property values and this is why the general perception of interest rate increases is viewed negatively by real estate market participants. However, if the rate increases were precipitated by positive economic news, net operating incomes will rise and even with rising cap rates, values can climb.

The short-term problem for the market is that if rates increase today, by this afternoon, the mortgage rate quote from your lender is likely to be higher. The increases in net operating income don't kick in until leases roll, which is short term for residential apartments but longer term for offices and retail spaces.

We have been in an extraordinarily low interest rate environment for about nine years now. Long periods of low interest rates, while great for real estate capital markets, are indicative of monetary and fiscal policies that are not working. Rates have been so low for so long because the recovery since the Great Recession has been mediocre at best. Now that the economy is picking up, rates will rise and that is not necessarily a bad thing.

The increases in property values in New York City have also been below what would have been expected with rates being so low for so long. Since the low point (either 2009 or 2010 depending on borough), values have approximately doubled. But take into consideration that values dropped, on average, 38 percent from peak to trough in the last cycle, values today, while near all-time highs, are only about 20 percent above 2007 peaks. This reality flies in the face of the thesis that long periods of low interest rates create asset bubbles (it is important to note that many market observers blame former Federal Reserve Chairman Alan Greenspan's keeping rates too low for too long as the catalyst for the housing market crash which led to the Great Recession).

The investment sales market correction, now in its 30th month, appears to be winding down with sales volumes expected to rise this year while property values bottom out in an apparent replay of 1993 and 2010. Both of those years had similar dynamics at the end of market corrections. So the question today is if the interest rate increases will thwart the positive momentum we are seeing in sales volume and how property values might be impacted.

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